RICHARD RUSSELL'S **DOW THEORY LETTERS, INC.**

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Feb. 27, DJIA 974.58; PTI 1409; A-D Ratio –18.16
Mar. 6, DJIA 974.58; PTI 1409; A-D Ratio –18.11

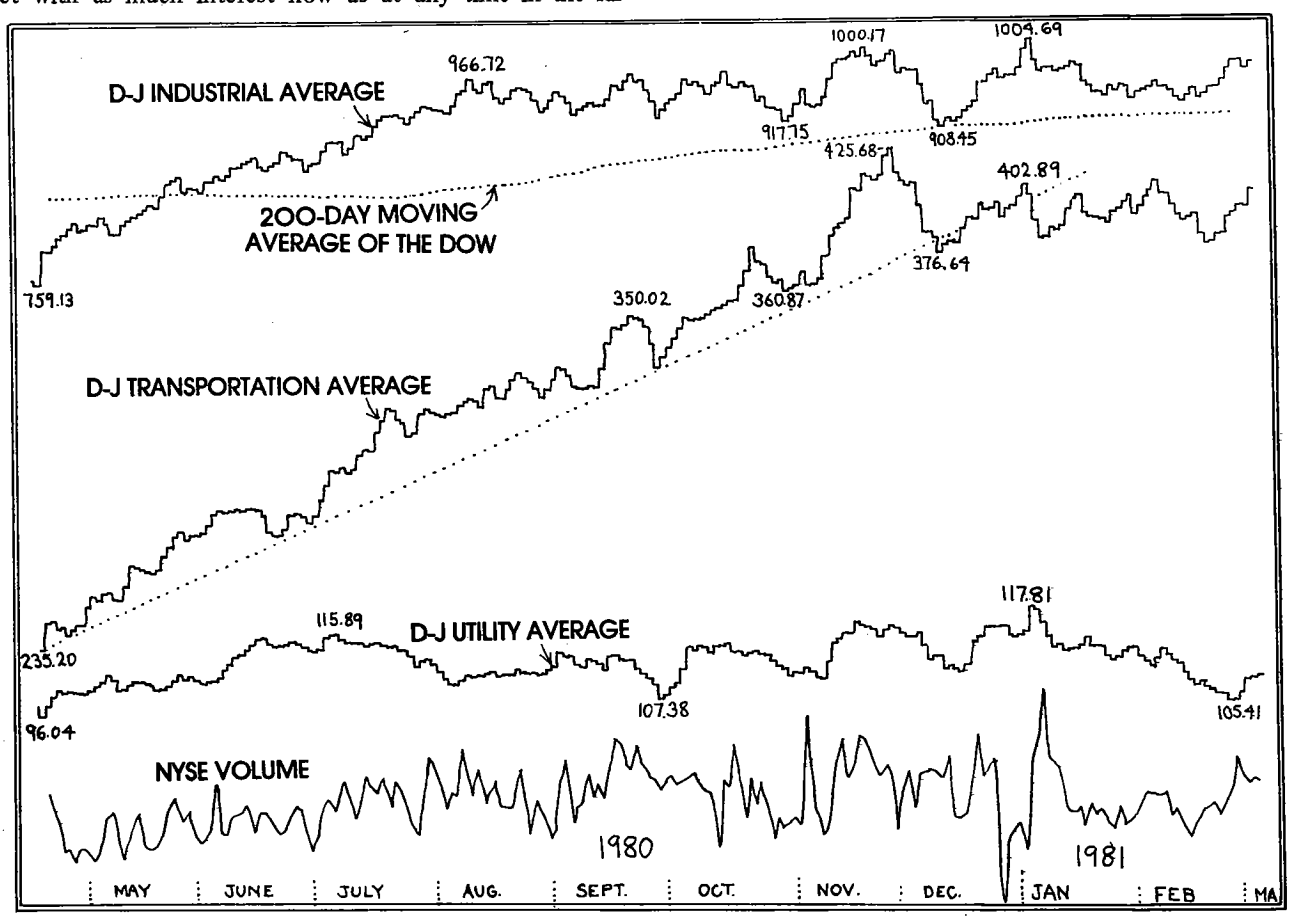
THE PICTURE: With bonds near bear market lows, with gold and silver swooning, with commodities smashing across the board, I have to wonder if the deflation scenario hasn't already started. As readers know, I've been saying for two years that the rising and totally unsustainable levels of US debt must lead to either hyper-inflation (as a method of floating the debt) or collapse and deflation. To put it another way, the nation must either "inflate or die."

If this nation was moving towards hyper-inflation, I would expect gold, silver, and commodities to be surging off into the wild blue yonder. Yet this is hardly the case. Many consider the falling price of gold "simply a reaction to gold's high flying frenzy of last year." I'm skeptical. The move from the 103.50 low of 1976 to last year's high took gold up 747 points. The halfway level of that great rise was 476. On March 2 the 476 level was cracked. Thus gold has failed to hold half of the 1976-80 gains. That, it seems to me, is more than a mere downward correction. I think gold is " telling us something."

I consider the collapse in commodities, bonds and gold and silver–as half of the story. The stock market constitutes the other half–and the stock market has certainly *not* handed down its verdict yet. I've grown up in this business with the firm conviction that the stock market is the ULTIMATE BAROMETER. I am still of that opinion. Therefore, I think I'm watching the stock market with as much interest now as at any time in the last

FRONT PAGE COMMENT: Due to "errors," the Reagan Administration is asking for an additional $6 billion in budget cuts. Meanwhile, the budget deficit for the first four months of fiscal 1981 is over $40 billion, up 28% from last year. I'm projecting a 1981 budget deficit of $60 to $70 billion. This will be the announced budget deficit. But you can then add $46 billion of "off budget" deficits, and this will take the total actual deficit to over $100 billion! So we have more of the same, and the main difference between this year and last year is that now we have an Administration that KNOWS the nation is in trouble. But as long as we have presidents who put balancing the budget off into the future, US finances will lack credibility in world money markets. There isn't a veteran investor alive who believes the US budget will be in balance in 1982 or 1983.

Meanwhile, a Presidential commission, after 30 months of study, recommends mandatory, privately financed pensions for all Americans while raising the Social Security retirement age to 68. My translation: Social Security isn't going to make it so we had better get a privately **funded** pension plan into action–and fast. And we'll also push up the SS retirement age to the point where most of the poor slobs will be dead before they can ever collect.

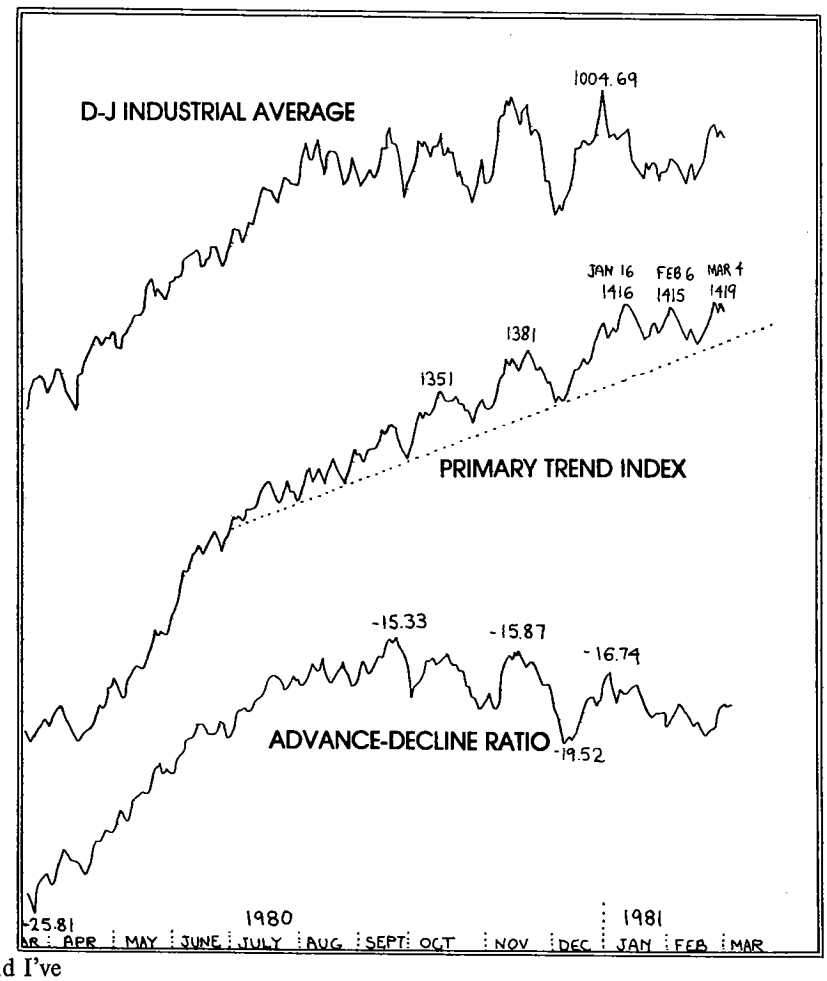


25 years. I'm watching with such interest because I feel that as long as the stock market holds, any major trouble in this nation will be held off (and maybe, just maybe, things will somehow "work out.") But if Wall Street follows commodities, gold and bonds off the edge of the cliff, then to put it succinctly, I'd say we were in deep trouble!

STOCK MARKET: There's been a lot of huffing and puffing to the upside over the last few weeks, but a glance at the page 1 chart shows us a rather confused picture. During 1980 up to November, it was the Transportation and Utility Average that led the way higher – with Industrials lagging. Now it is the Industrial Average that has the "oomph" but the Transports are lagging and the Utilities are dragging far behind.

The fact is that the Averages are still in the same "no man's land" that I discussed in the last Letter, that hazy territory below the last highs but above the preceding lows. An "all clear" for the bulls would entail Industrials bettering 1004.69 confirmed with a Transport bettering of 425.68. A bear triumph would be an Industrial plunge below 908.45 confirmed with a Transport breaking of 376.64. And remember, from the Dow Theory standpoint, a penetration of one Average, unconfirmed by the other, is more than likely to prove deceptive.

So that's it – almost four months have passed without producing a clear trend in the Averages.



PRIMARY TREND INDEX: The PTI is my proprietary index. It's an amalgum of eight critical market averages and indices. I developed the PTI during the late 1960's and I've charted it on a daily basis since 1971. As veteran subscribers can testify, it has proved a most remarkable instrument.

I consider the PTI an indicator of the basic, underlying trend of the market. Those who have done battle with the stock market over the last year know that the trend of the market is often murky and enigmatic. It is in these areas that the PTI reaches its greatest usefulness. When the PTI is in a persistent rising trend, it exerts bullish pressure under the market. The market may not rise step for step with the PTI, but importantly, the market will never cave in while the PTI is in a PERSISTENT uptrend – and this is an important consideration. The exact converse is true when the PTI is in a persistent declining trend.

A perfect example of this rule has been seen during the period following January 6. Since that date all kinds and varieties of market "sell signals" were given, record downside volume was seen (on Jan. 7), interest rates pushed near all-time highs, but still the market failed to fall apart. During this period, as you can see on the daily chart, the PTI held stubbornly above its long, rising trendline.

The fact is that in the period since June, 1980 the PTI dipped close to, or actually touched, the rising trendline on six separate occasions. But each time, instead of violating the trendline, the PTI pushed higher. In so doing, it was telling me and subscribers that the basic trend of the market was bullish (and many times this was hard to believe!).

On January 16 the PTI hit a high of 1416. It dipped, then moved up to 1415 on February 6. Another decline, and then on March 4 the PTI recorded a new high of 1419. Looking at the chart I do not know (at this time) whether the PTI has formed a "triple top" in the 1415-1420 area – or whether the PTI is about to move out on the upside. One fact is clear, however, and that is that despite weakness in almost every other segment of the market, the PTI is still holding above its rising trendline. I have stressed for months that I do not expect any real market trouble until, or unless, the PTI violates that trendline.

As an aside I will say that in the 10 years that I have charted the PTI, I have never seen a potential triple-top formation such as the one that now appears on the chart. As of this writing, the PTI stands at roughly the same level it was back in January 16, two months ago.

Conclusion: A trend is conceded to remain in force until PROVED otherwise. The action of the Averages and the PTI remain bullish – and I have no proof to the contrary.

Question: What do you think of investments in the so-called Strategic Metals? (IRT, New Orleans)

Answer: Such investments worry me a bit. The main reason they worry me is that if a real scarcity of any one or group of strategic metals develops, I would expect the Government to immediately take over all contracts as an emergency step. Also, I like to put my money in items which have great liquidity. Contract volume in strategic metals is, in most cases, thin.

Question: In case of deflation, the Government may pay off its debt by only a portion of what it owes: e.g., if the Government owes interest on its T-bills of $100, it may only pay $10, in effect reducing the dollar to 10% of its value. This has happened in Europe a number of times. I realize the price of other items would change concurrently but I still cannot be sure in my own mind that the holding of T-bills is the wisest thing in case of deflation. I am fearful of the future ability of the Government to honor its commitments. (Dr. P.W., Seattle)

Answer: You ask one of the most difficult questions imaginable. And that's the reason I write 26 Letters a year instead of one or two. Things change, events change, laws change, economics changes. Right now T-bills are very safe. But six months or two years from now I may recommend no T-bills and all gold or half gold and half stocks. Unfortunately, there is no long-term safety in any single investment today. We've got to move to fit the situation, and often we have to move fast.

Question: Russell, you write so much about what's wrong with the country, why don't you go into politics yourself? (RUR, Stamford, Conn.)

Answer: Someone (I think it was Max Lerner) said that "politics is the art of the possible." What's possible in politics is almost always a compromise. I like to think that I search for the facts, the truth–rather than what is possible. At any rate, what fascinates me is the truth of things, not the politics of things. I believe that the reason so many politicians are crooked is that politics attracts men who like manipulation and compromises, rather than the truth. If you know that 2 plus 2 equals 4, you're not going to compromise and say that "OK, it equals 3.4 or something around 4."

When I see the debt of the US going out into space, I want to talk facts and truth about that debt and its implications. The art of the possible doesn't work when you're dealing with compound interest rates and debt–as Washington will find out during the next one to three years. In the meantime, I'll write the truth as I see it–and sleep better for it.

Question: You mention "off budget" expenses of the Government. What are you referring to, Russell?

Answer: Roughly half the off-budget expenses come from the Federal Financing Bank. The other half come from so-called "Government sponsored enterprises." The FFB purchases the obligations of various on-budget agencies such as the Export-Import Bank, TVA, the Farmers Home Admin., etc. The Government sponsored enterprises carry out various loan programs such as Student Loan Marketing, FNMA, Federal Home Loan, etc.

The whole off-budget concept amounts to a giant deceit, a lie to the creditors of the US. Debts are debts regardless of labels, and the off budget deficits simply serve to obscure the enormity of the US debt fiasco.

NOTES & QUOTES: New books: Harry Browne, you're not really lazy (as you claim), it's all an act. Harry and Terry Coxen have come up with a new book entitled "**Inflation-Proofing Your Investments**" (Morrow, $14.95). It's a fat book, big print, excellent graphs, and chock full of Harry Browne intelligence, common sense, and uncommon sense. The book covers everything from stocks, gold and silver to avoiding taxes and building an intelligent portfolio. Harry has the faculty of making difficult subjects seem easy. Maybe he's just a good writer. At any rate, I liked this book and learned quite a bit from it. I recommend it highly. After all, any man who can play "21" in a Bahamas casino for 12 hours straight and only lose $20 has to be a genius!

* *

Godfather (to my son, Ryan) Harry Schultz has come out with a new book, "**Harry Schultz's Bear Market Investment Strategies**" (Dow Jones, Irwin). This is an excellent and informative book–even the preface is a gem. Harry loves to collect investment wisdom and common sense strategies. He has a way of thinking that I find both fascinating and clear. In case you haven't guessed, I like this book and recommend it. And it deals with a little known subject–bear markets (everybody else is concerned with bull markets).

* *

It's most unusual that I review any book, but now I have a third book that I want to review and recommend. This book is "**The Great Money Panic**" by Martin Weiss. You can buy it ($14.95) from Weiss, PO Box 2923, W. Palm Beach, FL 33402, and it is published by Arlington. Martin Weiss and his father, Irving (old friends of mine) are two of the really original minds in economics. The Weiss's were talking (and telling me) about the coming crisis in debt years and years ago. This book is a fascinating excursion into a world few people understand–finance. The book deals with the coming disaster of the debt situation and I recommend it to all readers. As I said, the Weiss's are thinkers–original thinkers!

* *

From Cliff Harris, talented climatologist with the Reaper (PO Box 39026, Phoenix, AZ 85069) "I think that we're going to have the most severe weather in more than 500 years during the next decade (the 1980's)...I'm more convinced than ever that world weather conditions will continue to deteriorate rapidly until 1983 or perhaps 1984. Food related catastrophes (famines) are almost a certainty from the way I view things weatherwise. As US farmers tighten their grip upon the world's dwindling food supply, prices should respond accordingly. Already world grain stocks are at dangerously low levels."

I reprint this because Harris's record is good and what he says is important. I also happen to think that compared to other things, food is still cheap. Rent now takes 1/3 of most American's income (it used to be 25%). Food, particularly vegetables and chicken and grains are cheap compared with rent, transportation, services.

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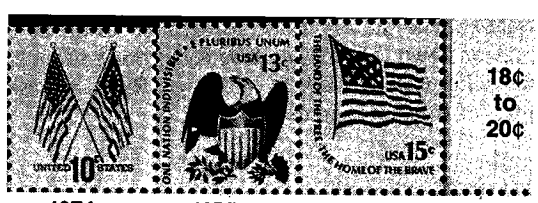
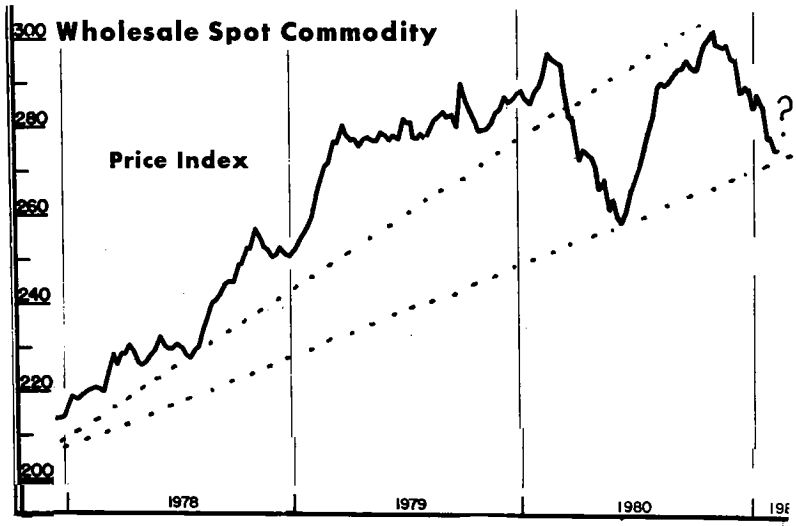
Here's a story of government mis-management, all told in pictures.



There's been plenty of weakness in commodities this year, but inflation isn't dead yet. I've been watching the wholesale spot commodity index, and a glance at this chart shows you that some deflationary forces have hit the super-sensitive wholesale commodity area. But if the 1980 lows are taken out, I'd say that inflation is in trouble. BUT–that hasn't happened yet. We'll watch.



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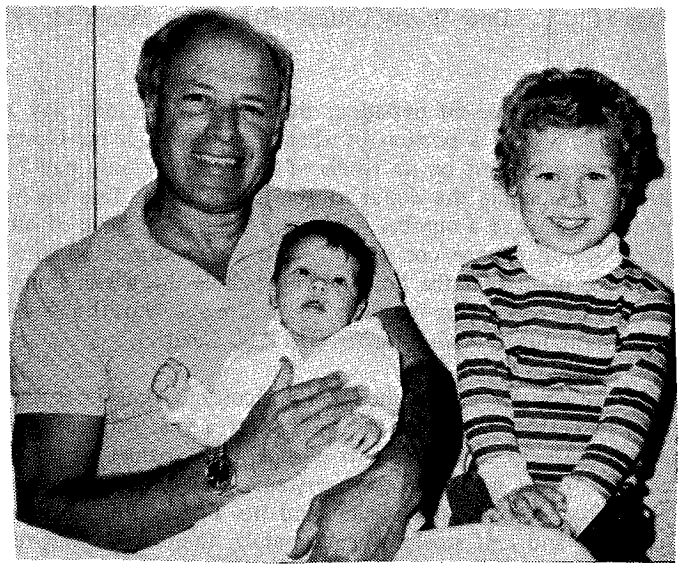
When they asked Willie Sutton, the famous bank robber, why he spent most of his adult life robbing banks, Sutton replied, "That's where the money is!" People ask me why I am so sure that the social programs (which Reagan will not touch) will have to be cut back. I answer, "That's where the real spending is!" I think a glance at this chart of transfer payments will back up that statement.

GROWTH IN US TRANSFER PAYMENT PROGRAMS (1970-1980)

		$ BILLIONS 1970	1980E
VETERANS BENEFITS	77.3%	6.6	11.7
RAILROAD RETIREMENT	193.8%	1.6	4.7
SOCIAL SECURITY	297.0%	29.7	117.9
UNEMPLOYMENT INSURANCE	321.6%	3.7	15.6
MILITARY PENSIONS	325.0%	2.8	11.9
PUBLIC ASSISTANCE (WELFARE)	343.9%	4.1	18.2
MEDICAID & MEDICARE	382.8%	9.9	47.8
FEDERAL EMPLOYEE RETIREMENT	429.6%	2.7	14.3
SCHOOL LUNCH PROGRAM	900.0%	.4	4.0
HOUSING ASSISTANCE	960.0%	.5	5.3
FOOD STAMPS	1350.0%	.6	8.7
		63.2 ..	266.9 ..

* *

In interviews and elsewhere I am often asked the question, "Russell, what do you do in your spare time?" "I lie down," is my usual answer. The reason for the comatose position is shown in this photograph. All kidding aside, here I am with my suntan and my two latest pride-and-joys, Lauren (age 10 weeks) and Ryan (just had his 3rd birthday). In all honesty, my good wife, Paula, does most of the chores where the mighty mites are concerned, while I make the big decisions such as "is the stock market going up or down." So far, neither Ryan nor Lauren have expressed much interest in markets, although Ryan has asked me about the trends for sugar and cocoa.



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I looked at a super-glossy two page magazine ad for the new Lincoln Continental, and I ask myself, "Has the US auto industry lost its mind? Or are they just reliving the 1950's? " At any rate, this cartoon seems to be making a valid point!

CONFLICTING VIEWS: The Optimist's View: Ever since World War II, following each Presidential election we have seen a significant market decline in the following year. The post election declines have stemmed from either (1) a let-up in the euphoria generated by the election of the new President, or (2) the market's discounting the tougher times and stemer measures which have been promised by the new President.

We're in this kind of situation now. President Reagan and his people are going to bring in tough new measures which, although highly constructive, are bound to cause early dislocations in business and finance. Thus, the year 1981 will be a difficult year or even a bear year for the market. But 1981 will also be a BASE-BUILDING year. From whatever important low is established in 1981, the stock market can be expected to commence a major new bull market. Thus, any weakness that emerges in 1981 should be viewed as a golden opportunity for investors.

Along these lines John Templeton, the most successful of all fund managers, has noted that in the last 12 years stocks have done nothing. "This is a most unusual situation," he states. "We are now about ready to experience the next great bull

market." Noting that stocks are now selling at 8 times earnings, he expects an eventual return to 14 times earnings. Templeton figures that there is a "better than 50/50 chance that American share prices will triple in the next eight years."

Templeton states that replacement values are close to record lows, so low that corporations today often pay 50% to 100% over market value to take over other corporations.

From the patient long-term investors standpoint, the worse the news, the bigger the fear–the more advantageous for the 1981 buyer. What the big investor would love now would be a frightening decline to a major, "over-sold" bottom in 1981. This would provide the launch-pad for what could easily be the best bull market seen in years.

The Pessimist's View: The pessimist agrees with all the foregoing arguments. The pessimist takes his hat off to John Templeton, his intelligence, his historical overview, his remarkable record. Except for one thing, and that one thing will throw a giant monkeywrench into all the glowing concepts of the optimists. The one thing is DEBT. Never in world history has any nation had to deal with the kind of debt the US now has to deal with. And any calculations which do not take the debt of the US, its corporations and its citizens into account, are doomed to disappointment.

No bull market in history has ever begun with the pathetic kind of corporate liquidity that we see today. No bull market has ever begun with near-record interest rates. No bull market has started with the consumer strapped for cash, with a tight Federal Reserve policy and a new Administration firmly dedicated to bringing down inflation. Bull markets begin amid excess liquidity, easy credit and pent-up demand. These are hardly the conditions in the US today.

True, the pessimist will give the concept of values its due. If US stocks were not "bargains" in the historical sense of the word, then in view of what is happening in the financial world stocks would now be sinking to perhaps the equivalent of Dow 400. What today's great values have succeeded in doing is holding stocks up in a sort of no-man's land trading range. This is perhaps most visible in the Dow, an Average which has been stuck in a trading range for 15 years.

Thus, argues the pessimist, historical values put a floor under the market while horrendous debt and financial problems put a lid on the market. Caught between these twin forces, stocks fluctuate aimlessly, groups rotate, fashions change–but basically nothing of note occurs in the markets.

The next major move will come when either the debt-credit-financial situation moves towards real solution, or when the markets collapse under the weight of the greatest debt pyramid the world has ever seen. Furthermore, states the pessimist, the classic solution to the debt-credit-financial situation is the squeeze, the wipe out, the mass bankruptcy. Such a solution would, in the long run, be healthy for the economy. But it would express itself through a bear market of unbelievable ferocity. "So much for today's great values in the stock market," states the pessimist.

INVESTMENT POSITION: Subscribers are (I think) beginning to see the wisdom in my insistence that liquid assets be held in US Treasury bills. Right now, I believe that T-bills are THE PLACE to be. Yes, own a house if you are able, hold a few gold coins if you wish, hang on to your beloved stamp or coin collection, all on the principle of DIVERSIFICATION. I've said before, and I repeat, when the whole financial system of the nation is shaky, it's the person who loses the least who is the ultimate winner.

At some time ahead I may recommend switching our T-bills into what's left of the Government bond market, or I may recommend major positions in stocks. I frankly don't know what I "may recommend" a few months or a year out. But right now it's basically T-bills.

If we hit another bond market panic (and we could), if we hit a situation where there's a headlong rush for cash so that consumers and business and Government can stay afloat, we may see what I have referred to as "an interest rate spike." If so, long-term Treasury bonds could plummet and Treasury yields could go to 15-16-18% or higher! If that happens I will want Treasuries. But that's a "possible story" for later on, and right now we want to be safe, short-term debt backed up with the highest credit – Treasury bills.

GOLD: The support at 482 did not hold, and last week gold plunged to a March 5 morning low fix of 457. To my mind, the most important level for gold now is the halfway point of the entire bull market rise from 35 to 850. That level is 442. Gold has already broken the halfway point of the 1976-80 rise of 103 to 850 – the 477 level. A decisive breaking of the 442 level would be very discouraging for gold bulls, and to me it would suggest that the back of the entire gold bull market had been shattered.

For a different perspective on gold I am including (page 6) my long-term ratio chart of gold, showing the action from 1968 to date. I have felt all along that the first phase of the bull market for gold was the rise from 35 to 194, a rise which took place during 1970 to 1974. This is the phase where only true investment sources accumulate the metal. The first phase ended with the dive to 103 in August, 1976. The second phase of the bull market took gold to 850 during early-1980. The second phase is the one in which there is some (but limited) public participation. On the chart we see that at 850 the metal had spiked far above the top of the channel. I noted this at the time and said that such enthusiasm is usually followed by an equal amount of pessimism. For this reason, it would not be unusual to see gold sink back (correct) to the middle of the rising channel, as seen by the dotted line at channel-center. This would take gold to about the 440-450 level.

Question: Russell, what is the third phase and what would bring on a third phase in gold?
Answer: The third phase of a bull market is the one in which the public comes in "with both feet." We have not seen this kind of participation yet. In fact, at its peak I doubt if ½ of 1% of adult US citizens owned any gold at all. That was not exactly third phase participation. I have stated dozens of times that the reaction following a bull market's second phase is usually the most DECEPTIVE of all the reactions. It is here that cries of "bear market" and "it's all over" are usually heard. Even now I doubt (except for Jim Dines) if there is a gold bull around. Such are the conditions prior to a possible third phase.

What could cause a third phase in gold? We could see a situation in which Congress fights Reagan on most counts (actually, many

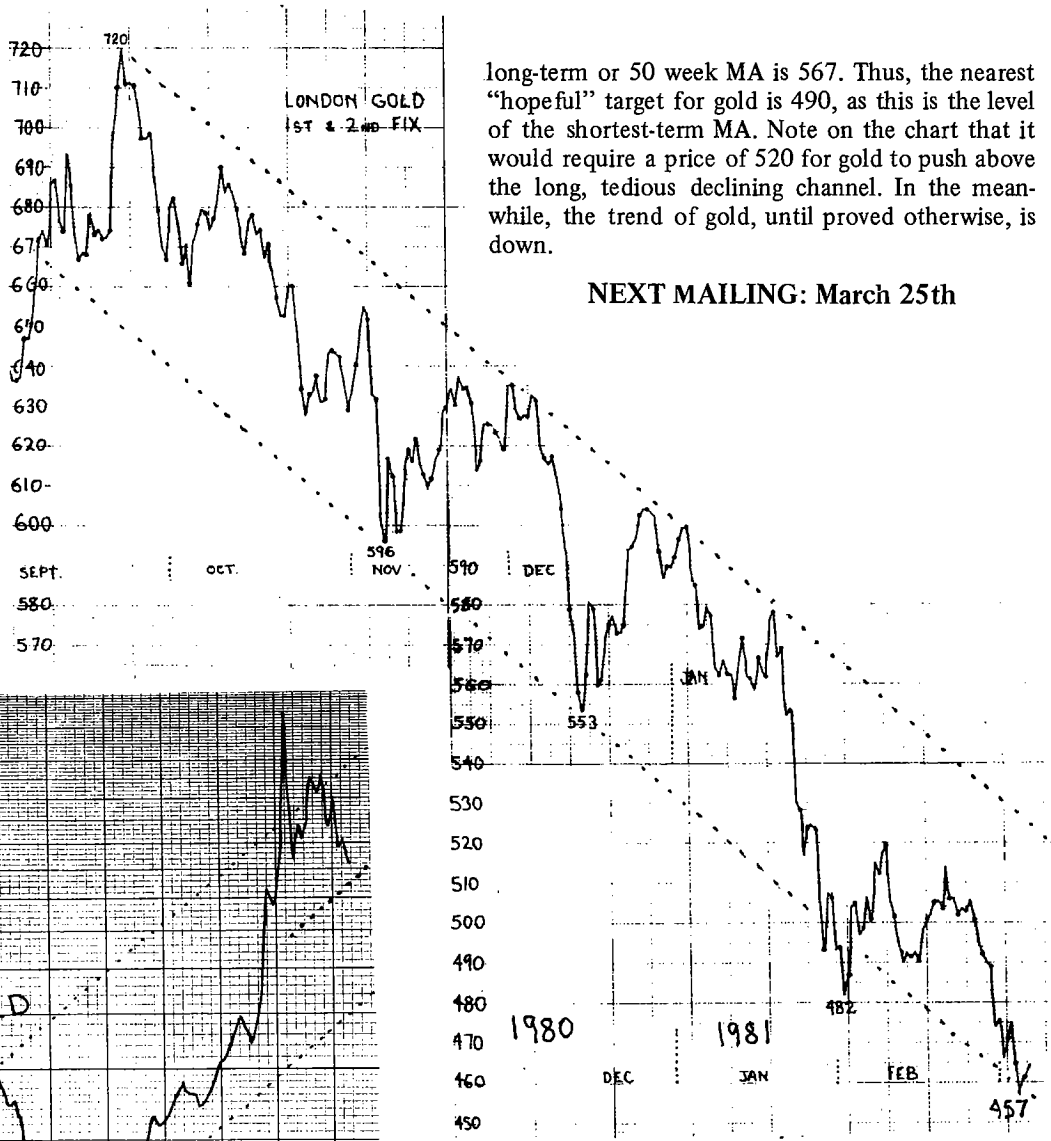
of Reagan's bills might not even get out of committee until November). We could see defense spending rise, inflation continue, Government expenses get totally out of control bringing about a final, disastrous run on the dollar. With debt eating up what's left of dollar credibility, with foreign currencies suspect, conditions might be right for a mass panic into "something of real value" – gold. In other words, if the present hopes for budget containment under Reagan turns into a pipe dream, the third phase for gold could be ushered in.

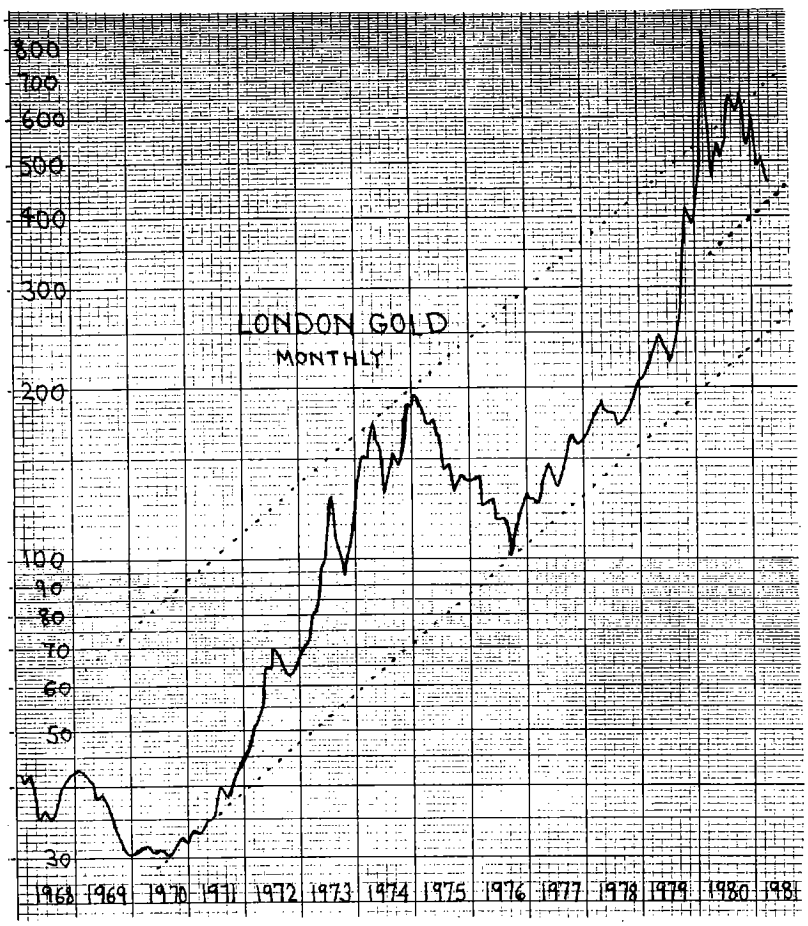
Question: Russell, what do you think the odds of the foregoing coming to pass are?

Answer: I think the odds for a coming third phase of the bull market in gold are better than 50/50. I do not put the odds higher, because a third phase in gold would mean a collapse of the dollar. The collapse of a great currency is a rare and disastrous event, and the odds on that kind of thing occurring is always slim. But it could happen. For instance, some day we'll get a great earthquake in California but I would never bet more than 50/50 that a major earthquake will occur here within say the next two years.

For the nearer term, it is well to know that the 5-week moving average for gold is 490, the 13-week MA for gold is 531 and the long-term or 50 week MA is 567. Thus, the nearest "hopeful" target for gold is 490, as this is the level of the shortest-term MA. Note on the chart that it would require a price of 520 for gold to push above the long, tedious declining channel. In the meanwhile, the trend of gold, until proved otherwise, is down.

NEXT MAILING: March 25th





"Get in there, Denby, and cut fat!"

(Courtesy of New Yorker)